Agenda Number: 25 Section Name: {{section.name}} File ID: {{item.tracking_number}}

TO: City Council

FROM: Drew Corbett, City Manager

PREPARED BY: Community Development

MEETING DATE: July 15, 2019

SUBJECT:
Below Market Rate Inclusionary Housing Program - Modifications

RECOMMENDATION:
Provide direction on modifications to the City's Below Market Rate Inclusionary program.

BACKGROUND:
One of the 2018-19 City Council priorities was to evaluate increases in the affordability requirements to the City's Below Market Rate (BMR) Inclusionary Program. This is also an area of interest identified by participants at the recent Home for All Community Conversations: Housing in San Mateo. The City's existing BMR program was enacted in 1992 in accordance with provisions of Measures H and P and revised in 2010 based on recommendations of the Technical Advisory Committee (TAC) on the Housing and Land Use Study in 2008.

City's Current BMR Program Requirements
The current program requires that for residential projects with 11 or more units, the developer set aside a percentage of the total number of units, rental or for sale, for inclusion in the city's affordable housing program. The current program requires that projects with rental units provide either 10% of the total number of units affordable to very low income or 15% of the total number of units affordable to low income households.

In addition, developers shall pay an in-lieu fee for fractional units from .1 to .4, but the required number of BMR's is rounded up for fractional units over .5. For example, a rental project with 24 units will provide two very low units onsite and pay a fractional fee of .4 (10% of 24 units = 2.4 affordable units), but a 25-unit project would provide three very low-income units (10% of 25 units = 3 affordable units). Also, small projects consisting of 5-10 units also pay a fractional in lieu fee as adopted by the City Council (see Attachment 1 for 2018 Below Market Rate Housing Program Maximum Unit Rates).

The option to provide either 10 or 15% of the total project as affordable resulted from the work of the TAC in 2007-08. At that time, the economic analysis model demonstrated that the return to investors for providing 10% of the total units affordable to very low households and 15% to low income households was equivalent. The expectation was that different developers would choose different options and produce a variety of units for the program. To date, no developer has ever chosen the 15% option for either rental or for-sale projects.

To qualify for BMR units, the City utilizes area median income (AMI). Median income changes by family size, and as an example, in San Mateo, the median income for a family of four in 2018 was $118,400. As it relates to the inclusionary requirements for rental units, a family of four would need to have gross annual income below $59,200 (50% of AMI) to qualify for a very-low income unit or $94,720 (80% of AMI) for a low-income unit. Each year, City Council adopts a resolution using area median income to set maximum rental and sales prices for the affordable units produced by the BMR program.

Considerations for BMR Program Modifications

Based on Council direction, the City contracted with Economic & Planning Systems (EPS) to evaluate options to revise the current BMR program. The analysis was intended to answer the following:

- How do San Mateo BMR requirements compare to neighboring jurisdictions?
- Are the existing requirements creating major feasibility issues?
- Can the existing requirements be increased or better balanced?
- Can different standards be created for different housing types?
- How can the program be modified if density is increased in the future?

<u>Neighboring Jurisdictions</u>
The California legislature adopted AB 1505 in 2017, which reaffirmed the authority of cities to adopt and impose inclusionary requirements. AB 1505 was passed in response to a court case in Los Angeles in 2009 referred to as the "Palmer" decision. This case made a finding that the inclusionary rent restrictions violated State laws that regulate rent control, causing most cities in the state to stop enforcing their inclusionary requirements on rental properties, while some switched to impact fees as an alternative.

Since AB 1505 was adopted in 2017, many cities revisited or adopted new inclusionary requirements. Locally, Redwood City, Daly City, South San Francisco, and Mountain View all adopted new requirements. Neighboring cities have affordability requirements ranging from 10-20% of the units in a project, targeting a broad range of income groups. San Mateo has similar requirements, and in some cases, lower than other local jurisdictions. The variances are attributed to slight differences in housing markets, and underlying development assumptions (height, density, intensity and parking requirements), as well as policy goals. For example, Redwood City assumed 225 dwelling units per acre (DU/acre) when they evaluated the economic feasibility in their ordinance while the San Mateo model assumes 50 -68 DU/acre (See Attachment 2).

<u>Feasibility and Sensitivity of BMR Standards</u>
EPS evaluated both the current San Mateo BMR standards as well as potential revisions. EPS developed five "prototype pro formas" to look at construction types that are typical in San Mateo, including the following and their base densities:

- 5 story apartments over podium parking (50 DU/acre),
- 5 story apartments with wrap parking (50 DU/acre),
- 5 story condominiums (50 DU/acre), and
- Townhomes (24 DU/acre)

Based on the current market conditions, the City's existing BMR standards are feasible, which is borne out by the fact that housing construction is active. However, according to the study by EPS, the current 10% and 15% options do not result in equivalent outcomes for developers. For both rental and ownership projects, the yield on the 15% option is lower than the 10% option, and therefore not as attractive to developers. This is reflected in charts A-1 – 5 in Attachment 3 and represented by the profit margin.

The State Density Bonus law overlaps with City requirements and affects the project economics. For example, a project that provides 10% very low rentals can get a 32.5% density bonus, but a 15% low income project is eligible for a 27.5% increase in density. The increase in the value of the additional market rate units offsets the costs to provide very low-income units over the low-income units. The City has seen a significant increase in developers utilizing Density Bonus in the past few years. Recently, the developers of the former Trags and AAA sites have voluntarily provided 11% very low-income rentals to obtain a 35% density bonus.

<u>Rental Construction</u>
Attachment 3 includes the draft economic analysis provided by EPS. Tables 1-6 include the income and development cost

assumptions for the various prototypes. Tables A-1 and A-2 summarize a number of scenarios tested at various income levels and two construction types for rental projects. Given the current high development costs and the City's existing general plan and zoning requirements, the very low income inclusionary option can likely increase marginally (11-12%) and still make projects economically viable. It may not be possible to increase the current 15% option without changing the income target group to moderate income. The final columns of the tables demonstrate that additional density would be required to make the current 15% low income option equivalent to the financial return for the current 10% very low option that developers are selecting.

For- Sale Construction
Tables A-3 and A-4 demonstrate that both current BMR options are economically feasible but again the 10% option is more attractive. Although this creates opportunities for low income homebuyers, it is sometimes difficult to find qualified buyers for these units. An increase of the current moderate-income option could be possible if the low-income option is eliminated since it is more economically attractive to developers, as shown in the feasibility analysis in Attachment 3.

Currently, townhome development appears to generate the highest financial returns of all the prototypes. One way to level the playing field with higher density housing is to increase the BMR requirements for townhome projects. For example, the City of Mountain View recently adopted a 15% inclusionary requirement for most housing but set a minimum of 25% for townhomes.

Density Analysis

The City Council's 2019-20 Priorities include the workplan item that staff evaluate increasing the inclusionary housing requirement to 20%. As shown by the economic analysis, this would not be financially feasible without significantly increasing the income target groups to moderate income or above and eliminating options for very low or low income households within the current density provisions of Measure P. EPS was asked to run scenarios with higher densities to test the feasibility of deeper affordability options. Within the existing height limits and using wood frame construction, 100 DU/acre is achievable and could provide additional affordable units since the development costs per unit decreases and the costs of affordable units can be spread over more units. Table A-5 of Attachment 3 includes scenarios with a base density of 100 DU/acre that illustrate a number of options that are feasible. These are not currently allowed under the provisions of Measure P but are attached to illustrate the relationship of density and development costs of housing and provide analysis for future consideration.

Policy Considerations

Currently, the City's BMR requirements coupled with the State Density Bonus provisions promote fewer units at lower income levels. The scenarios prepared by EPS demonstrate several options the City could consider. These options include:

1. Should the inclusionary percentages be increased?
   - The inclusionary percentages could be increased slightly to 11 or 12% for very low income rentals or low income for- sale units, which would provide a small number of additional affordable units.

2. Does the City want to continue to offer two options at different income levels?
   - The City could eliminate the current 10% option which would force developers to provide 15% units at higher income targets with only slight modifications to the current program.
   - Some neighboring cities require a range of incomes for the affordable units rather than one income group or another. This assists a range of households but could complicate administration for property managers and staff.

3. Should the City consider different requirements for different housing types?
   - Higher BMR standards for townhomes may level the playing field with higher density housing. Townhome development appears to generate the highest financial return for developers, showing greater profit margins as compared to all other prototypes studied.

Staff requests feedback from the Council to provide additional analysis and provide a recommendation moving forward.

BUDGET IMPACT:
There are no costs associated with the City's inclusionary policy other than current staff administration of the program.

ENVIRONMENTAL DETERMINATION:
In accordance with CEQA Guidelines Section 15262, an activity involving only feasibility or planning study for possible future actions does not require the preparation of an environmental impact report or negative declaration. Any future action to modify the City's BMR program will receive environmental review prior to the action being considered by the Planning Commission and City Council.

NOTICE PROVIDED
All meeting noticing requirements were met.

ATTACHMENTS
Att 1 - 2018 Below Market Rate Housing Program Maximum Unit Rates
Att 2 - Inclusionary Requirements of Neighboring Jurisdictions
Att 3 - Economic Analysis Model

STAFF CONTACT
Sandra Council, Housing Manager
scouncil@cityofsanmateo.org
(650) 522-7223